

Time for a new lease?

Richard Hough, a practitioner in pharmacy law, suggests that it is maybe worth renegotiating a lease in these difficult economic times



The economic downturn has made life hard for commercial landlords and retail tenants alike. Landlords are understandably concerned about asset depreciation, the solvency of their tenants and their own ability to place future tenants in any unoccupied premises. Pharmacy contractor tenants are also feeling the economic squeeze due to reduced profit margins and uncertainty over future bank funding whilst experiencing nagging doubts that all the while they might be bound by rent obligations which no longer reflect economic realities. However, such challenging economic times also present opportunities for pro-activity to help alleviate the uncertainty and concerns shared by both landlords and tenants and it may well be in both parties' interests to consider initiating the renegotiation of the lease which currently binds them.

Needless to say, it is not just pharmacy tenants and pharmacist landlords who need to grasp the nettle: the entire commercial property industry has been forced to reconsider ways in which to negotiate, renegotiate and structure long-term leases.

Practical steps

So what practical steps can be taken and what can one hope to achieve from lease renegotiations?

First of all, it is vital for both parties to communicate any real or potential problems to the other before these problems become insurmountable. This will help the renegotiation process to achieve realistic, mutually beneficial results.

Flexibility in payment structures, tailored terms of engagement for specific groups of retailers and initiatives to find economies of scale for service management charges or ongoing fees are all potential options for consideration.

However, formalising these agreements by taking action sooner rather than later could prove to be critical to each party's long-term success.

There are three key options landlords and tenants wishing to be proactive need to discuss as a matter of priority: rental flexibility; service management; and engagement efficiencies. By raising these issues with the landlord, a tenant will feel that steps are being taken to secure their premises for the medium to long term,

the landlord's properties are more likely to be kept full and active and the risk of incurring empty property charges will be diminished.

Rental flexibility

Once the process of renegotiation has been initiated, it is of paramount importance to the success of the process for both parties to adopt an economically realistic negotiating position — one that accurately reflects the difficulties facing businesses in the current economic climate. Landlords will also need to be increasingly flexible and creative, albeit within existing parameters, when entering into new agreements with new tenants.

Landlords have to be commercially realistic enough to acknowledge that it might be prudent for them to work sensibly with their current tenants and help alleviate their short

or to strengthen an existing guarantee, but convincing a tenant to add or strengthen a guarantee can be difficult. However, from a landlord's perspective, gaining such a concession can be valuable if the tenant's business fails but the guarantor retains significant assets.

The objectives of renegotiation are different for each party. The landlord will be looking for the best way to protect his assets and the tenant for the best way to secure his current premises. However, landlords need to bear in mind that, if they have taken out a loan to acquire or develop their property, they should consult their loan agreement, as financial covenants imposed by the lender may restrict their ability to renegotiate the lease.

Service management

There are many ways in which service charges can be reduced in order to lower the amounts that tenants pay to landlords, but tenants must be aware that asset protection will always be the landlord's primary objective, irrespective of the changes to service management provision.

Any changes made to service management agreements will involve a tenant assuming responsibility for some aspect or aspects of service provision, either for a limited period or on an ongoing basis. For instance, tenants could elect to self-insure, rather than be bound by the terms of the landlord's insurance policy. Landlords making this concession should ask to be named on the tenant's policy, which would enable them to retain influence over the insurance agreement if and when the time comes to revert back to the original service management terms. Tenants and landlords must work together to ensure the acceptability of any amendments made to service management contracts, as simply handing power over to tenants could lead to additional, unwelcome pressure for the tenant and an unacceptable loss of control for the landlord.

If the pharmacy or commercial property is situated within a larger scheme (eg, a major retail park), greater economies of scale can be achieved by the tenants sharing ownership of communal services such as cleaning. Again, this needs to be agreed by both parties, and the landlord will need to give explicit consent and ensure that a method of benchmarking success

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term financial concerns, if only because they themselves do not have the luxury of a line of prospective tenants looking to move in. However, this acknowledgement should not mean that tenants should automatically seek to gain the upper hand in contract negotiations. For every concession made by a landlord in favour of the tenant — eg, rent discounts, deferred payment periods or rent free periods — landlords have counterbalancing options at their disposal, such as lengthening the term of the lease, amending rent review mechanisms and increasing rent frequency. Lengthening the term of a lease, for instance, can benefit a landlord looking to stabilise a property's cash flow for a longer period. Landlords can also use the opportunity of lease renegotiation to gain a guarantee on a previously unguaranteed lease

is in place. Landlords will also need to ensure that they can ultimately regain control of service management where, for instance, the tenants' efforts are found wanting.

Retendering service contracts is also an effective way of reducing tenants' costs. In the current marketplace, economically embattled suppliers may be desperate to secure new business and may be under pressure to reduce their margins in order to maintain existing business. Therefore, they may be able to offer competitive rates to landlords looking for services across a portfolio of properties or to tenants looking to restructure the services currently being provided at their premises.

Engagement efficiencies

Landlords have an excellent opportunity in the current market to open debate with their tenants to explore further ways of achieving efficiencies of scale, which work to both parties' advantage. It is critical that these discussions are used to create effective and mutually beneficial contractual agreements that can, if necessary, be replicated across all of the landlord's properties. Lawyers can subsequently create user friendly, *pro forma* leases for landlords that can be implemented across an entire property portfolio.

Transparency and empowerment are also excellent by-products of these types of engagement. Landlords can demonstrate to their tenants that there are no hidden costs and tenants also feel empowered because they are actively involved in reshaping their contracts for the medium to long term.

Conclusion

The economic downturn is proving tough enough without spurning opportunities to lessen the hardship. Pro-activity and willingness to enter into discourse should, where necessary, be implemented as a matter of commercial expediency. However, rental renegotiations should not be seen as an opportunity for one party to gain the upper hand over the other. Contracts need to be drafted so that they are transparent, clearly worded, commercially realistic and strong enough to withstand the pressures of the downturn but also flexible enough to keep landlords happy, tenants secure and the properties attractive as investments.

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